

Bankruptcy's effect on commercial leases

Landlords and tenants should learn their rights and obligations when legal actions take place



LEGAL EASE

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One of the sectors hit hardest during the current economic meltdown has been commercial real estate. The credit crisis has made refinancing of maturing loans nearly impossible. Many otherwise stable businesses have encountered their own cash crunch problems. Sometimes, a bankruptcy is the only means to salvage the situation. Following is a look at how a bankruptcy can affect commercial landlords and tenants.

A bankruptcy is commenced upon the filing of a petition for relief with the bankruptcy court. The petition can be voluntary – when it is filed by the debtor; or involuntary – when creditors of the debtor file the petition. The commencement date is an important concept, because it creates a stay on any action that a creditor may otherwise have against a debtor. At that point, a creditor must seek relief from the bankruptcy court before taking any action against the interest of the debtor.

In bankruptcy terms, a lease is a form of an executory contract, which is any contract that requires the future performance of some obligation by the debtor.

For a landlord, the future performance could mean making possession of the real estate available to a tenant, perhaps maintenance obligations, paying for utilities or future tenant improvements.

For a tenant, the future performance would include payment of rent and also could involve maintenance obligations.

The bankruptcy code gives the debtor the right to assume or reject any executory contract, including a commercial lease. In a Chapter 11 proceeding, the debtor has 120 days from the commencement date to elect assumption or rejection, with limited rights to extend the decision date. In a Chapter 7 proceeding, the bankruptcy trustee must decide in 60 days.

If the debtor is a tenant, assumption of the commercial lease by the debtor-tenant requires that all pre-petition and post-petition defaults be cured, including payment of all past-due rent. If the bankruptcy proceeding is still pending and if the debtor-tenant thereafter defaults on the assumed lease, the landlord could assert its remedies after getting relief from the automatic stay.

A significant expense of any business is the lease. A debtor-tenant may want to use the bankruptcy to escape a lease that is higher than market or renegotiate the lease for more favorable terms during the time it has to assume or reject the lease. A landlord is unable to take any action against the debtor-tenant during this decision-making process.

Conversely, the lease may have value to the debtor tenant. It may choose to assume the lease and then assign it to a third party for a price in excess of the lease rent. In most cases, the landlord would need to consent to the assignment.

A rejection of the lease by a debtor tenant results in the termination of the lease.

Navigating one's way through a bankruptcy as either a landlord or a tenant is a challenge that requires knowledge of the rights and obligations under the bankruptcy code and the lease itself. Clearly, professional consultation should be sought.

In that situation, the landlord has an administrative claim for the rent that was due between the commencement date and generally the date the debtor tenant vacates the property. An administrative claim is valuable because it has a higher priority when it comes to the payment of claims.

Damages for pre-petition unpaid rent are general unsecured claims against the debtor-tenant and are paid last in the order of priority and pro rata with all of the other unsecured creditors. If the debtor-tenant rejects the lease but fails to vacate, the landlord must seek relief from the bankruptcy court to evict the debtor-tenant.

A landlord who is in bankruptcy has the same right to assume or reject a lease. If it's assumed, the relationship between the parties is unaffected by the bankruptcy.

Both the landlord and the tenant have the obligation to perform the lease as written. If the lease is rejected by the debtor-landlord, the tenant retains the right to possession of the real property during the term of the lease.

However, the debtor-landlord's financial obligations under the lease, such as maintenance of the property, payment of utilities or future tenant improvements, are terminated. The tenant would have the right to offset against future rent any of the lease obligations of the landlord that the tenant was forced to assume as the result of the rejection of the lease.

In some instances, a debtor in bankruptcy can be both a landlord and a tenant.

A common example is when a party enters into a ground lease, builds a building on the leased property, and then leases the completed building to subtenants. The debtor's assumption/rejection decision in these cases can create drama.

In some states, the rejection of the ground lease by the debtor is an automatic termination of the subleases. In a poor economy, this may be the excuse a subtenant is looking for to escape its obligations under the lease without liability. The ground-lease landlord is then left with taking over a building with only a few tenants or none at all.

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